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In the Supreme Court of the United States

OCTOBER TERM, 1967

No. ____

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

NATIONAL SECURITIES, INC., ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

The Solicitor General, on behalf of the Securities and Exchange Commission, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit entered in this case on November 14, 1967.

OPINIONS BELOW

The opinion of the court of appeals (Appendix A, *infra*, pp. 1a–16a) is not yet reported. The opinion of the district court (Appendix B, *infra*, pp. 18a–24a) is reported at 252 F. Supp. 623.

JURISDICTION

The judgment of the court of appeals was entered on November 14, 1967 (Appendix A, *infra*, pp. 16a–17a). On February 10, 1968, Mr. Justice Douglas extended the time for filing a petition for a writ of

certiorari to and including March 4, 1968. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the McCarran-Ferguson Act, Section 2(b) of which provides that no Act of Congress shall "invalidate, impair or supercede any law enacted by any State for the purpose of regulating the business of insurance * * * unless such Act specifically relates to" that business, precludes the application of the anti-fraud provisions of the Securities Exchange Act of 1934 to false and misleading statements made in soliciting stockholder consents to a merger of insurance companies.

STATUTES AND RULE INVOLVED

The relevant provisions of the McCarran-Ferguson Act, 59 Stat. 33-34, 15 U.S.C. 1011-1015, Section 10(b) of the Securities Exchange Act of 1934, 48 Stat. 891, 15 U.S.C. 78j(b), and Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. 240.10b-5, are set forth in Appendix C, *infra*, pp. 25a-27a).

STATEMENT

The Securities and Exchange Commission instituted this action in March 1965 in the district court to enjoin respondents National Securities, Inc. ("National Securities"), its subsidiary National Life and Casualty Insurance Company ("National Life"), and certain officers and employees of one or both of those companies, from violating the anti-fraud provisions of the Securities Exchange Act of 1934 (Section 10

(b) of that Act and the Commission's Rule 10b-5 thereunder) (R. 1-14).[1] The district court dismissed the suit on the pleadings (R. 804), and the court of appeals affirmed (App. A, *infra*, pp. 1a-16a), on the ground that the action was barred by the McCarran-Ferguson Act, Section 2(b) of which says (App. C, *infra*, p. 25a):

> "No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance * * * unless such Act specifically relates to the business of insurance."

1. The Commission's complaint made the following allegations—which the court of appeals stated "must be presumed by us to be true" (App. A, *infra*, p. 8a):

National Securities is a holding company which owned two-thirds of the 1,018,574 outstanding shares of National Life, an insurance company incorporated in Arizona. Producers Life Insurance Company, Inc. ("Producers Life"), another insurance company incorporated in that State, had 881,976 outstanding shares of common stock, held by approximately 14,000 stockholders in many States. The defendants formed

[1] Section 10(b) makes it unlawful to use, in connection with the purchase or sale of any security in interstate commerce or through the mails, "any manipulative or deceptive device or contrivance" in contravention of the Commission's rules. Rule 10b-5 makes it unlawful, in connection with such purchase or sale, "to employ any device, scheme, or artifice to defraud," to make "any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made * * * not misleading," or to engage "in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." App. C, *infra*, pp. 26a-27a.

an illegal scheme, in violation of the anti-fraud provisions of the Act, by which (a) National Securities would acquire control of Producers Life, (b) National Life and Producers Life would be consolidated, and (c) the consolidated company would pay a large part of National Securities' cost of acquiring control of Producers Life (R. 425–428).

As a step in obtaining control of Producers Life, National Securities purchased the stock of that company held by four of Producers Life's directors, and agreed to pay them large sums in return for their agreement not to compete with Producers Life or any successor company. At the same time National Securities purchased from Producers Life more than 50,000 shares of its treasury stock, and assumed its liabilities of more than $600,000 stemming from prior agreements Producers Life had obtained from other persons not to compete with it (R. 428).[1] National Securities did not disclose to Producers Life or its stockholders that it intended to impose these liabilities upon the corporation that would result from the planned consolidation of Producers Life and National Life (R. 433–434).

[1] National Securities purchased 50,203 shares of treasury stock for $2.20 per share, and also assumed liabilities payable over approximately eight years of $537,891. National Securities' simultaneous purchase of 27,416 shares of Producers Life from four of the latter's directors was at $20.79 per share, and its purchase from a company controlled by the same directors of 38,694 shares of Producers Life was at $9.50 per share. In addition, the four directors were to be paid $979,000 over the next 10-year period for their agreements not to compete (R. 428–429).

After obtaining control of Producers Life, National Securities caused the latter to mail to its stockholders material soliciting them to approve the proposed consolidation with National Life. This material was false and misleading because, among other things:

a. It did not disclose that the consolidated company would assume National Securities' liability of more than $1,400,000 on the agreements not to compete.

b. It repeatedly predicted that the consolidated company would have net earnings of more than $460,000 annually, but did not disclose that Producers Life and National Life had losses in the prior year (1964) of approximately $70,000 and $35,000, respectively.

c. It set forth in the pro-forma balance sheet for the consolidated company an asset shown as "Treasury Stock $1,174,556" that was "illusory."

d. It did not disclose that in its 1964 Annual Report to the Arizona Insurance Commission, National Life had written down on its books the value of its stockholdings in Producers Life from $1,164,000 to $641,658 (R. 433–437).

2. Upon the filing of the Commission's action, the district court entered a preliminary restraining order which barred the defendants from violating the antifraud provisions of the Act but which did not prevent them from submitting the consolidation plan to the stockholders for approval (R. 437–438). The stockholders accepted the plan, the Arizona Insurance Commissioner approved it and the defendants effected the consolidation (R. 437–439). The Commission then filed an amended and supplemental complaint (R.

440-442) in which it requested broader relief than it originally had sought.

In granting the defendants' motion for judgment on the pleadings, the district court held (1) that the McCarran-Ferguson Act precluded the application of the anti-fraud provisions of the Securities Exchange Act of 1934 to the "requested relief of invalidation by this Court of the corporate merger, now finally approved by the Arizona Director of Insurance"; and (2) that the Commission's request for "an accounting for unjust enrichment and other relief * * * would be inappropriate * * * and would, in all events, fall out-

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* In addition to the injunction previously sought, the Commission requested that the defendants be required "to take all actions and measures which are necessary to rectify and correct the consequences of the[ir] wrongful and unlawful conduct * * * and to restore Producers Life, National Life, their stockholders and the defendants to the status and economic condition which they occupied prior to April 27, 1964 [the date of the alleged agreement between National Securities, Producers Life and the four selling directors thereof]"; that the defendants "make an accounting of the extent to which their [illegal] actions and the [illegal] actions of the selling directors * * * have resulted in damage to such stockholders, and the extent to which the defendants have been unjustly enriched at the expense of such stockholders"; and that "by suitable decree of the Court, the respective equities of the defendants and the stockholders of Producers Life be arranged and adjusted on a fair and equitable basis, including, if warranted on the basis of the accountings made by the defendants, the subordination of the stock interests and other equities of National Securities in National Producers [the consolidated company] to the interests of those stockholders whose equities have been diminished by reason of the unlawful and wrongful conduct of the defendants" (R. 440-442).

side the scope of available relief provided in § 21(e) of the 1934 Act" (App. B, *infra*, pp. 23a–24a).

The court of appeals affirmed on the ground that the McCarran-Ferguson Act barred the action, and did not pass upon the propriety of the relief that the Commission sought. The court stated that in the McCarran-Ferguson Act Congress "define[d] an exemption for insurance conterminous with its power to regulate interstate commerce"; that the legislative history of that Act disclosed "a general intention to set the insurance business outside the scope of all existing and future legislation regulating interstate commerce, without any more direct evidence that Congress had in mind the Securities Exchange Act"; that the provision in Section 4 of the McCarran-Ferguson Act making it inapplicable to the National Labor Relations Act, the Fair Labor Standards Act and the Merchant Marine Act, 1930, indicated that Congress believed that otherwise those statutes would not apply to the business of insurance; and that in the McCarran-Ferguson Act Congress wished "to preserve intact from any federal intrusion based on the commerce clause, existing and future State regulation of the insurance industry" (App. A, *infra*, pp. 11a–12a). The court concluded its opinion with the statement that it

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[4] Section 21(e) authorizes the Commission to bring an action in the district court to "enjoin such acts or practices" that appear to the Commission to violate the Act or its rules thereunder, and provides that "upon a proper showing a permanent or temporary injunction or restraining order shall be granted * * *." 15 U.S.C. 78u(e).

was "in accord with" the following "views expressed by the district court":

> [T]he requested relief of invalidation by this Court of the corporate merger, now finally approved by the Arizona Director of Insurance pursuant to A.R.S. § 20-731, would at least "impair", if not "invalidate" or "supercede" (sic) laws enacted by the State of Arizona "for the purpose of regulating the business of insurance", within the meaning of the applicable provisions of the McCarran Act. [App. A, *infra*, p. 16a.]

REASONS FOR GRANTING THE WRIT

The holding of the court of appeals is that the McCarran-Ferguson Act (App. C, *infra*, p. 25a) precludes the application of the anti-fraud provisions of the Securities Exchange Act of 1934 to false and misleading statements made in soliciting stockholder approval of mergers of insurance companies because such application of the Securities Exchange Act would "invalidate, impair, or supersede" the law enacted by the State of Arizona "for the purpose of regulating the business of insurance" within the meaning of Section 2(b) of the McCarran-Ferguson Act. This holding creates a serious gap in the comprehensive investor protections that Congress provided in the Securities Exchange Act and is, we submit, an erroneous construction of the McCarran-Ferguson Act.

Mergers and consolidations of insurance companies are frequent. The most recent edition of the standard reference work on life insurance lists 164 combina-

tions of life insurance companies alone during the two-year period ending December 31, 1966;[1] the figures undoubtedly would be even higher if mergers of other types of insurance companies were included. A large number of these companies have public stockholders. The need to protect stockholders against such misrepresentations as were allegedly made in connection with the consolidation of National Life and Producers Life is no less compelling for investors in insurance companies than for investors in other businesses. The traditional thrust of State insurance regulation has been the protection of policy holders, not stockholders. Cf. *Securities and Exchange Commission* v. *Variable Annuity Life Insurance Co., et al.*, 359 U.S. 65, 78–79 (concurring opinion of Mr. Justice Brennan). Only the antifraud provisions of the federal securities laws can provide insurance company stockholders with the full measure of protection Congress intended investors to have.

1. In Section 3(a)(10) of the Securities Exchange Act of 1934, Congress adopted a broad definition of "security" in order "to protect investors through the requirement of full disclosure by issuers of securities" (*Tcherepnin* v. *Knight*, 389 U.S. 332, 336). Section 10(b) of that Act makes it unlawful to use any manipulative or deceptive device or contrivance "in connection with the purchase or sale of *any* security registered on a national securities exchange or *any* security not so registered." (emphasis added). In the face of this clear congressional intent to extend the

[1] Best's Life Insurance Reports, pp. 1595–1602 (62d ed. 1967).

antifraud provisions to all sales and purchases of securities—and for many years the Commission has held that an exchange of securities such as was involved in the consolidation of National Life and Producers Life constitutes a "sale" of securities under the antifraud provisions of the Securities Exchange Act of 1934 and the Securities Act of 1933[*]—an exception to the general broad scope of this important public legislation should not be created by implication unless it is clearly required by some other federal statute. The McCarran-Ferguson Act does not manifest any congressional intent, either in its language, design or legislative history, to carve out any exception from the antifraud provisions of the Securities Exchange Act for securities of insurance companies that are being consolidated.

The "basic purpose" of the McCarran-Ferguson Act "was to allay doubts, thought to have been raised by this Court's decision of the previous year in *United States* v. *South-Eastern Underwriters Assn.*, 322 U.S. 533, as to the continuing power of the States to tax and regulate the business of insurance" (*Federal Trade Commission* v. *Travelers Health Association*, 362 U.S. 293, 299; see, also, *Prudential Insurance Co.* v. *Benjamin*, 328 U.S. 408, 429). "Accord-

[*] The courts of appeals for the Second and Seventh Circuits recently upheld the Commission's position on this question. *Vine* v. *Beneficial Finance Company*, 374 F. 2d 627 (C.A. 2), certiorari denied, 389 U.S. 970; *Dasho* v. *Susquehanna Corp.*, 380 F. 2d 262 (C.A. 7), certiorari denied *sub nom. Bard* v. *Dasho*, 389 U.S. 977. Twenty-five years ago the Ninth Circuit held to the contrary, *National Supply Co.* v. *Leland Stanford Junior University*, 134 F. 2d 689, certiorari denied, 320 U.S. 773.

ingly, the Act contains a broad declaration of congressional policy that the continued regulation of insurance by the States is in the public interest, and that silence on the part of Congress should not be construed to impose any barrier to continued regulation of insurance by the States" (*Wilburn Boat Co. v. Firemen's Fund Insurance Co.*, 348 U.S. 310, 319). In addition, Section 2(b) of the Act provides that "[n]o act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating [or taxing or imposing a fee upon] the business of insurance, * * * unless such act specifically relates to the business of insurance"; it further provides that the Sherman, Clayton and Federal Trade Commission Acts "shall be applicable to the business of insurance to the extent that such business is not regulated by State law."

Because Congress did not define "the business of insurance," the meaning of that phrase must be determined by reference to the basic purpose and design of the legislation and the problems with which Congress was concerned. In *South-Eastern Underwriters* this Court had held for the first time that interstate sales of insurance policies and business activities related thereto constitute interstate commerce subject to congressional regulation under the Commerce Clause. But prior to that decision it never had been thought that interstate transactions in securities of insurance companies were any more beyond the reach of congressional power than transactions in securities of other companies. The federal securities laws, enacted ten years prior to *South-Eastern Underwrit-*

ers, drew no such distinction, and these laws have been applied both before and after the McCarran-Ferguson Act to sales of securities of insurance companies.[7] Nothing in the history or language of the McCarran-Ferguson Act indicates any congressional intent to re-examine this previously established federal regulatory jurisdiction over securities transactions. The Act was wholly a response to the *South-Eastern* decision.

[7] The annual reports of the Commission refer to various civil and criminal cases involving the application of the antifraud provisions of the federal securities laws to transactions in insurance company securities. See, *e.g.*, Fifth Annual Report of the Securities and Exchange Commission, Fiscal Year Ended June 30, 1939, p. 250, respecting transactions in stock of Suwanee Life Insurance Company; Seventh Annual Report of the Securities and Exchange Commission, Fiscal Year Ended June 30, 1941, p. 338, respecting transactions in stock of Texas Mutual Reserve Life Ins. Co.; Sixteenth Annual Report of the Securities and Exchange Commission, Fiscal Year Ended June 30, 1950, p. 207, respecting transactions in stock of Co-op Insurance Co.; Twenty-Fourth Annual Report of the Securities and Exchange Commission, Fiscal Year Ended June 30, 1958, p. 231, respecting transactions in stock of Great Fidelity Life Insurance Co.; Twenty-Fifth Annual Report of the Securities and Exchange Commission, Fiscal Year Ended June 30, 1959, p. 270, respecting transactions in stock of American Buyers Insurance Co. and Unity Insurance Co.

Prior to the decision below, in the only decided cases we have found in which the McCarran-Ferguson Act was cited as a defense to an alleged violation of the antifraud provisions of the federal securities acts in the sale of insurance companies' securities, the McCarran-Ferguson Act was held not applicable. *Securities and Exchange Commission* v. *American Founders Life Insurance Company of Denver, Colorado* (Civ. Action No. 6031, D. Colo., order dated May 7, 1958) and *United States* v. *Meade*, 179 F. Supp. 868 (S.D. Ind.).

See, also, *Hearings Before A Subcommittee of the House Committee on Interstate and Foreign Commerce on H.R. 6789, H.R. 6793, S. 1642*, 88th Cong., 1st Sess. 176 (1963).

In addressing itself to regulation of "the business of insurance" in that Act, therefore, Congress was referring to those activities of insurance companies which, under the constitutional interpretation prevailing prior to *South-Eastern*, were exclusively the subject of State regulation. These included such matters as rates, the content, form and issuance of policies, the operation of the business, the maintenance of proper reserves, the prevention of unfair practices in dealing with policyholders (cf. *Federal Trade Commission* v. *National Casualty Co.*, 357 U.S. 560), etc. It was only with respect to those matters—the "business of insurance"—that Congress intended to preclude the application of federal legislation because it was only in those areas that any threat of interference with settled State practices was posed by the *South-Eastern Underwriters* decision.

Traditional State regulation of insurance, however, did not generally extend to the policing of the practices by which the companies obtained stockholder approval of mergers. Since 1964, and in response to the amendments to the Securities Exchange Act in that year,[8] a number of State insurance commissioners have undertaken to regulate the solicitation of proxies and insider trading in connection with

[8] Prior to the amendments of 1964 most regulatory provisions of the Securities Exchange Act, including those relating to proxy solicitations, were applicable only to securities that were registered on a national securities exchange. The 1964 amendments, generally speaking, subjected to these provisions widely-held securities not traded on exchanges but provided an exception for securities of insurance companies that were subject to specified types of state regulation, including proxy regulation.

insurance company securities. But prior thereto this was not generally the practice.[9] In any event these changes in State regulatory policy neither enlarged the scope of the McCarran-Ferguson Act nor provided antifraud protections comparable to those contained in the Securities Exchange Act.

In sum, Congress did not intend the methods whereby insurance companies obtained the consent of their stockholders to mergers to constitute "the business of insurance" that was immunized generally from federal regulation.

This is the clear import of this Court's decisions in *Securities and Exchange Commission* v. *Variable An-*

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[9] This was recognized in testimony before a Subcommittee of the House Committee on Interstate and Foreign Commerce in regard to the 1964 Securities Acts amendments:

> The State insurance commissioners through their organization, the National Association of Insurance Commissioners, testified that they recognized some validity to the contention in the commission's special study report that their procedures were primarily directed to matters concerning the protection of policyholders and to the need for some improvement in these procedures insofar as they relate to the protection of investors in the stock of these companies. [H. Rep. No. 1418, 88th Cong., 2d Sess., 10 (1964).]

The Commission's Special Study of Securities Markets referred to above concluded:

> The operations of insurance companies are not supervised by any Federal Agency, but are regulated by the States in varying degrees. The emphasis, however, is consistently upon the solvency of the company, the adequacy of its reserves and the legality of its investments, rather than upon disclosure. In other words, State regulation of insurance companies is directed to the protection of the holders of insurance policies, not investors in insurance company securities. * * *. [Report of Special Study of Securities Markets of the Securities and Exchange Commission, H. Doc. No. 95, 88th Cong., 1st Sess., Pt. 3, Chap. IX, p. 40 (1963).]

nuity Life Insurance Co., 359 U.S. 65, and *Securities and Exchange Commission* v. *United Benefit Life Insurance Co.*, 387 U.S. 202. In holding there that variable annuities were "securities" under the Securities Act of 1933 rather than exempt "policies of insurance," the Court deemed it immaterial that the State regulatory authorities treated the companies as insurance companies and the annuities as insurance policies. In both cases the question whether the McCarran-Ferguson Act barred the application of the federal securities acts to the variable annuity contracts was argued.[10] In ruling that the variable annuities were "securities" subject to the federal statutes, the Court necessarily held that the McCarran-Ferguson Act did not bar the application of such statutes to the issuance of securities of insurance companies.[11]

2. The courts below further erred in concluding that the application of the Securities Exchange Act

[10] See brief for the petitioner, No. 290, 1958 Term, pp. 54–61; brief for respondent *Equity Annuity Life Insurance Company*, *ibid.*, pp. 38–43; brief for respondent *Variable Annuity Life Insurance Company of America*, *ibid.*, pp. 49–72. Brief for respondent, No. 428, 1966 Term, pp. 25, 42–43.

[11] See, also, *United States* v. *Sylvanus*, 192 F. 2d 96 (C.A. 7), certiorari denied, 342 U.S. 943, where the court, in upholding a conviction for mail fraud committed in connection with the sale of accident and sickness insurance policies, rejected the argument that the indictment was barred by the McCarran-Ferguson Act. It stated (p. 100): "we believe that it can not properly be said that this indictment has to do with the regulation of [the] insurance business in Illinois. Rather it has to do with the question of whether defendants have used the mails in pursuance of a scheme so to manipulate their authorized regulated business in Illinois as to result in fraudulent deceptions of its prospective policy holders."

to the consolidation of National Life and Producers Life would "impair", "invalidate" or "supersede" "laws enacted by the State of Arizona 'for the purpose of regulating the business of insurance'" (App. A, *infra*, p. 16a). The Arizona insurance law does not deal with or attempt to prevent misrepresentations in securities transactions, and we know of no State policy or statute designed to immunize such activities from regulation under the federal securities laws. The Commission's suit in no way sought to alter or modify any of the requirements that State law imposes upon insurance companies; its objective was solely to prevent misrepresentations in securities transactions and to obtain effective relief for shareholders who had been injured thereby."

3. Moreover, the court of appeals' decision rests in part upon the view that in the McCarran-Ferguson Act Congress provided "an exception for insurance conterminous with its power to regulate interstate commerce" and that, except for the three statutes to which the McCarran-Ferguson Act is made inapplicable by Section 4 thereof, federal regulatory legislation does not apply to insurance unless it specifically so states (App. A, *infra*, p. 11a). To that extent the effect of the decision would not be limited to mergers,

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"The district court held that the relief the Commission sought (see note 3, p. 6, *supra*) was not authorized by the statute and would be inappropriate (App. B, *infra*, pp. 22a–23a). The court of appeals did not decide the question. If this Court grants the petition and reverses on the McCarran-Ferguson Act issue, it should remand for the court of appeals to consider the relief question and the other issues tendered by the parties that it did not decide. Cf. *Federal Trade Commission* v. *Borden Co.*, 383 U.S. 637, 639.

but would generally apply to the antifraud provisions of both the Securities Exchange Act and the Securities Act of 1933. Indeed, this branch of the court's reasoning would even seem to preclude the application of the registration requirement in Section 5 of the latter act to the issuance of securities of insurance companies, since that Section, like the antifraud provisions of both statutes, does not specifically refer to insurance companies.

The decision of the court of appeals inevitably will have an unsettling effect upon the administration and enforcement of both of these important federal statutes, and is likely to lead to extensive litigation. Neither before nor after the enactment of the McCarran-Ferguson Act had there been any serious question as to the applicability of the federal securities laws to transactions in the securities of insurance companies.[12] Although the Securities Act of 1933 exempts from registration the issuance of insurance policies themselves (Section 3(a)(8), 15 U.S.C. 77c(a)(8)), the securities of insurance companies always have been registered before a public offering thereof has been made. Similarly, it never has been suggested that insurance companies whose stock is listed on a registered securities exchange are not subject to all the requirements of the Securities Exchange Act of 1934. Indeed, in its report on legislation enacted in 1964 (78 Stat. 565) that extended certain provisions of the Securities Exchange Act of 1934 to companies whose securities were traded only over-the-counter, the Senate Committee on Banking and Currency stated (S. Rep. No. 379, 88th Cong., 1st Sess.,

[12] See note 7, p. 12, *supra*.

p. 36 (1963)): "Stock insurance companies are presently subject to the provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934." [14]

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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MARCH 1968.

[14] Although the views of the Congress that enacted the 1964 legislation "provide no controlling basis from which to infer the purposes of an earlier Congress" that passed the McCarran-Ferguson Act, such views nevertheless are "pertinent." See *Haynes* v. *United States*, No. 236, this Term, decided January 29, 1968, slip op., n. 4, p. 2.